
Coates' Canons Blog: Preauditing Electronic Transactions Just Got (A Little) Easier

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The preaudit is a **statutory internal control** process to ensure that public funds are spent appropriately. If implemented properly the preaudit can be an effective tool in preventing and/or mitigating employee mistake, misappropriation, and even fraud. The problem with the preaudit process is that it is difficult to follow the strictures of the statute, particularly when conducting electronic transactions. **New rules**, promulgated by the State's Local Government Commission (LGC), will now make that process easier, or at least make it possible for local government entities to comply with the law. (The rules are part of the North Carolina Administrative Code (20 NCAC 03.0409 and 20 NCAC 03.0410).

This blog post reviews the requirements of the preaudit process and identifies when the process is triggered. It then discusses how the process can be carried out for certain electronic transactions, specifically purchase card (p-card), credit card, and fuel card transactions, under the new rules.

When is the preaudit process triggered?

The preaudit process is one of two internal control processes mandated by **G.S. 159-28** (for counties, municipalities, and public authorities) and **G.S. 115C-441** (for school units). (I'll refer to these entities collectively as local units.) (Note that the a separate preaudit process applies to ABC boards. See **G.S. 18B-702**.) The other internal control process in those statutes is the disbursement process, which is discussed briefly below. The preaudit process is performed before a local government entity obligates itself to pay money through a contractual agreement or similar arrangement.

That financial obligation can occur in a number of different forms. The most common forms involve issuing a purchase order to a vendor or contractor, entering into a written contract, placing a phone or internet order, and using a p-card, credit card, or fuel card to procure goods or services.

The exact trigger for the preaudit process occurs when all of these criteria are met:

1. The local unit issues a PO to a vendor, enters into a contract or a similar arrangement, places a phone or internet order, or uses a p-card, credit card, or fuel card to complete a financial transaction; AND
2. By the terms of the transaction, the local unit is obligated to pay money to another; AND
3. The local unit expects to pay out at least some of the money in the current fiscal year.*

*Note that if the budget appropriation that authorizes the expenditure is in a project or grant ordinance, as opposed to the annual budget ordinance (or budget resolution for school units), the third criteria is not required to trigger the preaudit.

There is no minimum amount to trigger the preaudit. It applies even if the amount involved is a \$5 supply order from a local vendor, or a \$1000 service agreement, or a \$15 million dollar construction contract. The preaudit requirement, thus, has no relation to a unit's internal PO threshold. (For example, a unit's PO threshold may be \$500, but any contract or purchase below this threshold still must be preaudited if the above criteria are met.)

What about electronic payments, such as p-cards, credit cards, and fuel cards – does the preaudit process apply to these types of transactions? The answer is clearly yes. When a unit uses a p-card, credit card, or fuel card to procure goods or services, it is actually obligating itself to pay the issuing bank/company when the bill comes due. And, again, the amount of the transaction does not matter for purposes of the preaudit requirement. That effectively means that all p-card, credit card, and fuel card transactions must be preaudited on a transaction-by-transaction basis. This has proven very difficult, if not impossible, for local units to do in practice.

What is the preaudit process?

The preaudit process requires that all of the following be done **before** a financial obligation is made (*ie.* before the goods are ordered or before the contract is executed):

1. The finance officer (or a deputy finance officer appointed by the governing board) checks to make sure there is a budget appropriation authorizing the transaction. Each finance officer/deputy finance officer must have a process that determines that there is an appropriation to the department, function code, or project, in which the transaction appropriately falls, depending on how the governing board budgets funds.
2. The finance officer (or a deputy finance officer appointed by the governing board) also checks to make sure that sufficient funds remain in the appropriation to pay out any amounts that are expected to come due this fiscal year. This step effectively requires a local unit to have some mechanism for tracking outstanding obligations.
3. If the contract or agreement is in writing (even electronically), it contains a preaudit certificate signed by the finance officer/deputy finance officer. The certificate language is: "This instrument has been preaudited in the manner required by the Local Government Budget and Fiscal Control Act."

If the preaudit process is not performed, in full, the contract or agreement is void. It cannot be enforced by either party. Furthermore, the board, in its discretion, may hold any employee or official who either entered into the agreement or caused it to be entered into, personally liable for the amounts obligated. And it constitutes a Class 3 misdemeanor to violate the statutory requirements.

There are some statutory exceptions to the third (3.) process requirement (preaudit certificate). A writing evidencing a contract or agreement does not have to contain the preaudit certificate if the contract has been approved by the LGC; if the contract involves a payroll expenditure, including one related to employee benefits; or if the contract involves a p-card, credit card, or fuel card transaction, but only if the local government unit follows the LGC rules related to electronic transactions.

New LGC Rules for Electronic Transactions

The LGC has now adopted those rules. As detailed in Memorandum 2018-05, the rules require the following:

RESOLUTION. The unit's governing board must **adopt a resolution** authorizing the unit to engage in electronic transactions. (The **LGC's memo** provides a sample resolution as an addendum.) That resolution authorizes the unit's employees and officials to use p-cards, credit cards, and/or fuel cards, and it either incorporates (by reference) the unit's written policies related to the use of those cards or authorizes the finance officer to prepare those policies.

ENCUMBRANCE SYSTEM. State law requires that certain local units that meet certain population thresholds (municipalities with a population over 10,000 and counties with a population over 50,000) incorporate encumbrance systems into their accounting systems. In order to comply with the new LGC regulations, all units will need to implement encumbrance systems. For units under the population thresholds listed above, the encumbrance system does not have to be incorporated into the unit's accounting system. In fact, for small units, it can be as simple as tracking expenditures against budget appropriations in a spreadsheet, or even on index cards. To facilitate individual transactions, though, a unit might want to create a shared electronic document that can be accessed by anyone authorized to make purchases.

POLICIES & PROCEDURES. The governing board or finance officer must adopt written policies that outline the procedures for using p-cards, credit cards, and/or fuel cards. At a minimum, the policies need to provide a process to ensure that **before each transaction is made**, the individual making the transaction:

1. ensures there is an appropriate budget ordinance or project/grant ordinance appropriation authorizing the obligation. (For school units, the reference should be to the budget resolution.)
2. ensures that sufficient monies remain in the appropriation to cover the amount that is expected to be paid out in the current fiscal year (if the expenditure is accounted for in the budget ordinance/resolution) or the entire amount (if the expenditure is accounted for in a project/grant ordinance).
3. records the amount of the transaction in the unit's encumbrance system, or reports the amount to another individual (either within the individual's department or within the finance department) to encumber. As stated above, in order to comply with this requirement, each unit must have an encumbrance system.

In addition to these requirements, a unit's p-card, credit card, and/or fuel card policies should address who has custody of the cards, who has access to the cards, what dollar limits are placed on the cards and individual transactions, what expenditure category limits are placed on the cards, and how transactions must be documented for reconciliation with the monthly bills. They should also state the consequences for failure to comply with the policies. The local unit's finance officer is responsible for overseeing all electronic payments and the policies should build in sufficient controls to allow the finance officer to carry out his/her duties.

TRAINING. Once the policies are enacted, the local unit must provide training to all personnel about the policies and procedures that are to be followed before using a p-card, credit card, or fuel card. Training should be repeated at regular intervals, and presented to all new employees and officials early in their tenures. And, the local unit's governing board needs to set an expectation of full compliance with the preaudit policies by all employees and officials.

QUARTERLY REPORTS. The local unit's staff must prepare and present to the governing board a budget to actual statement by fund at least quarterly. The statement needs to include budgeted accounts, actual payments made, amounts encumbered, and the amount of the budget that is unobligated. It is incumbent on the board to gain sufficient training on how to properly interpret these reports, in order to carry out the board's fiduciary responsibility to the unit.

Do units have to follow the new regulations?

The short answer is yes, if a local government unit uses p-cards, credit cards, and/or fuel cards it must follow the new regulations. The reason is that it is impossible to affix the signed, preaudit certificate to p-card, credit card, or fuel card transactions. It is not sufficient to perform the preaudit after the transaction is completed. (I describe the closest a unit could come to full compliance before the regulations were enacted in this **blog post**.) Because a transaction is void if the preaudit is not followed, a local unit will need to follow the new rules to come into legal compliance.

Adopting Resolutions & Policies

Conveniently, an addendum to the **LGC memo** contains a model resolution. Most local units should be able to fill in the

blanks and proceed with board adoption of that resolution in short order. The more difficult process will be the formulation of the various policies and procedures related to the electronic payment transactions. These are going to vary significantly by unit and by type of transaction. The policies need to be detailed enough to inform individual employees and officials of the exact steps they must take (and how to take them) before initiating a p-card, credit card, or fuel card transaction. At the same time, they need to be flexible enough to allow local officials to carry out their day-to-day responsibilities effectively. Finance officers may be well-advised to consult with department heads and others in their units and formulate policies that track existing business practices as much as possible.

To help local units get started with that process, here are a few examples of common electronic payment transactions. These should give finance officers a sense of the variation in the types of transactions their policies need to address.

1. The city clerk purchases food from a local grocery store for a board meeting in August. She uses a city-issued credit card to pay for the food. The city's credit card policy needs to establish a process whereby the clerk estimates the amount of the purchase and checks to see that there is a budget appropriation authorizing the purchase, and sufficient funds remaining in that budget appropriation to cover that amount. The city could set up a digital system whereby the clerk checks this herself or could require the clerk to work through finance to perform this budget check. (It's up to each unit to set up a process that best works with its operations.) Shortly after the actual credit card transaction, the clerk will need to encumber the amount purchased. It is not sufficient to wait until the monthly credit card bill comes in to make this encumbrance. It has to be done as close in time as possible to the actual transaction. Again, it will be up to each unit to decide whether to set up a system whereby the clerk makes the encumbrance herself or one in which the clerk submits the purchase amount to another to encumber. The policy also will need to establish a process for the clerk to submit the grocery receipt to finance for reconciliation when the bill comes due.
2. A county deputy sheriff needs to refuel his vehicle. He uses a county-issued fuel card to pay for the purchase. The county policy needs to provide a mechanism for the deputy to first ensure that there is a budget appropriation and sufficient funds remaining in that appropriation to cover the fuel purchase. In this case, it is likely not feasible for the deputy to do this check once he is on patrol. Instead, this general check could be done once a week, or within some other reasonable time period, related to all expected fuel purchases for the deputy's vehicle, or even for all of the sheriff's office vehicles, during that time period. Assuming there is going to be sufficient unencumbered budget appropriation to cover the expected fuel expenditures for the designated period, the deputy can proceed to make fuel purchases as needed. The policy needs to prescribe a process for the deputy to either encumber the amount of the fuel purchase shortly after it occurs or submit the amount to another to encumber. The policy also should provide a process to submit the transaction receipt to finance for reconciliation when the fuel bill comes due.
3. The executive director of a water and sewer authority orders supplies from an internet supplier, and uses the authority's p-card to make the purchase. As with the other examples, the water and sewer authority p-card policy needs to provide a process for the executive director to first check that this is an authorized p-card purchase, and to ensure that there is a budget appropriation authorizing the expenditure and sufficient unencumbered funds remaining in that appropriation. The policy also needs to set forth a procedure for encumbering the amount of the supply order either before or shortly after the transaction occurs. And, finally, the policy should address the process for submitting documentation of the transaction to finance for reconciliation.

These are just a few examples. A unit's policies ultimately will need to address all the different ways in which p-card, credit card, or fuel card transactions may occur. As these examples illustrate, the new regulations do not supplant the preaudit process in its entirety. They merely provide a workable alternative to affixing the preaudit certificate to an electronic payment. And these processes, alone, may not provide sufficient internal controls. Finance officers are well advised to implement additional controls in areas where misappropriations are more likely to occur.

Disbursement Process

The new rules also address electronic disbursements—namely, electronic fund transfers. The disbursement process is performed after the goods arrive or the services are performed and the bill comes due. The impact of the new rules on the disbursement process will be discussed in a future post.



Links

- www.nctreasurer.com/slg/Memos/2018-05.pdf
- www.ncleg.net/EnactedLegislation/Statutes/PDF/BySection/Chapter_159/GS_159-28.pdf
- www.ncleg.net/EnactedLegislation/Statutes/PDF/BySection/Chapter_115C/GS_115C-441.pdf
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